

## ANALYSIS OF AMENDED BILL

Author: Hurttt Analyst: John J. Pavalasky Bill Number: SB 1167

Related Bills: \_\_\_\_\_ Telephone: 845-4335 Amended Date: 1/5/98

Attorney: Doug Bramhall Sponsor: Author

**SUBJECT:** Conformity/Education Loan Interest Deduction

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ FURTHER AMENDMENTS NECESSARY.

☒ DEPARTMENT POSITION CHANGED TO Pending.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED \_\_\_\_\_ STILL APPLIES.

☒ OTHER - See comments below.

### SUMMARY OF BILL

This bill would conform California law to the federal deduction for interest on certain education loans contained in the federal 1997 Taxpayer Relief Act (Public Law 105-34).

### SUMMARY OF AMENDMENT

The January 5, 1998, amendment removes all of the previous contents of this bill and replaces it with a deduction for interest on certain education loans.

### EFFECTIVE DATE

This bill as a tax levy would go into immediate effect and apply to taxable years beginning on or after January 1, 1998.

### SPECIFIC FINDINGS

#### Background

The Tax Reform Act of 1986 repealed the deduction for personal interest. Student loan interest generally is treated as personal interest and thus is not allowable as an itemized deduction. Taxpayers, in general, may not

### DEPARTMENTS THAT MAY BE AFFECTED:

\_\_\_ STATE MANDATE

\_\_\_ GOVERNOR'S APPOINTMENT

Department Director Position:

\_\_\_ S      \_\_\_ O  
\_\_\_ SA    \_\_\_ OUA  
\_\_\_ N     \_\_\_ NP  
\_\_\_ NA    \_\_\_ NAR  
\_\_\_ X PENDING

Agency Secretary Position:

\_\_\_ S      \_\_\_ O  
\_\_\_ SA    \_\_\_ OUA  
\_\_\_ N     \_\_\_ NP  
\_\_\_ NA    \_\_\_ NAR  
DEFER TO \_\_\_\_\_

### GOVERNOR'S OFFICE USE

Position Approved \_\_\_\_\_  
Position Disapproved \_\_\_\_\_  
Position Noted \_\_\_\_\_

Department/Legislative Director      Date  
Gerald H. Goldberg                      2/23/98

Agency Secretary                      Date

By:                      Date:

deduct education and training expenses. However, a deduction for education expenses is allowed as a trade or business expense if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment. Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2% of the taxpayer's adjusted gross income (AGI).

#### Federal Law

Under the TRA of 1997, certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum deduction of \$2,500 for the 2001 taxable year. The maximum deduction is phased in over four years, with a \$1,000 maximum deduction in 1998, \$1,500 in 1999, \$2,000 in 2000, and \$2,500 in 2001. The maximum deduction amount is not indexed for inflation.

In addition, the deduction is phased out ratably for individual taxpayers with modified AGI of \$40,000-\$55,000 (\$60,000-\$75,000 for joint returns).

The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Qualified higher education expenses are defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from gross income for redemption of U.S. savings bonds, (2) any amount distributed from an education IRA and excluded from gross income, and (3) the amount of any scholarship or fellowship grants excludable from gross income, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that is excludable from the employee's gross income.

### California Law

California law generally is in conformity with the Internal Revenue Code as it read on January 1, 1997, as it relates to educational incentives, which do not allow a deduction for student loan interest.

**This bill** would allow a deduction for the interest paid by the taxpayer during the taxable year on any qualified education loan up to the following maximum amounts:

<u>Taxable Year</u>	<u>Maximum</u>
1998	\$1,000
1999	\$1,500
2000	\$2,000
2001 or thereafter	\$2,500

### Policy Considerations

Federal law specifically allows the deduction for interest on education loans to be taken in computing adjusted gross income (AGI). Thus, all taxpayers paying this type of interest receive the benefit of the deduction, not merely those who have itemized deductions which exceed the standard deduction. This is known as an above-the-line deduction. This bill does not conform to this above-the-line treatment for California purposes. The California treatment as a below-the-line deduction may not be of value to as many taxpayers as the federal treatment since those taxpayers otherwise claiming the standard deduction (rather than itemizing tax deductions) may not have sufficient other itemized deductions available to exceed the standard deduction amounts.

### Implementation Considerations

Federal law allows the deduction for interest on education loans to be taken in computing adjusted gross income (AGI). Thus, all taxpayers paying this type of interest receive the benefit of the deduction, not merely those who have itemized deductions which exceed the standard deduction. This is known as an above-the-line deduction. As an above-the-line deduction on the federal return, this interest deduction will appear on a significant number of the most simple returns (i.e. the 1040EZ and TELEFILE returns) of former students entering the work force in entry-level positions.

The California return begins with federal AGI. Since the bill currently does not contain language which would allow this same above-the-line treatment for state purposes, an adjustment to federal AGI would be required as well as allowing this deduction as an itemized deduction. Those adjustments can be made only on the long form 540. Thus, those taxpayers who previously filed the most simple state returns (i.e. 540EZ and TELEFILE returns) would now be required to file the long form 540 to take this deduction as an itemized deduction instead of an above-the-line deduction.

### Technical Considerations

Section 221 of the Internal Revenue Code, which is being conformed to by reference in this bill, did not exist on January 1, 1997, but was added to

the Internal Revenue Code by Section 202 of Public Law 105-34. Therefore, in order to incorporate this new federal section into California law, on page 2, line 4, after "Code" insert: as added by Section 202 of Public Law 105-34

#### FISCAL IMPACT

##### Departmental Costs

If the implementation consideration is resolved, this bill would not significantly impact the department's costs.

##### Tax Revenue Estimate

Estimates below assume actual enactment after June 30, 1998.

Fiscal Year Cash Flow Interest Payments Due After 1997 \$ Millions		
1998-9	1999-0	2000-01
(\$14)	(\$15)	(\$16)

##### Tax Revenue Discussion

The revenue impact for this provision would depend on the amount of qualified interest payments in any given year and the average marginal tax rate applicable to the deduction amounts.

These estimates were derived from information from the California Aid Commission Office on student loans. The vast majority of taxpayers would be former students (rather than parents) with modest incomes. It was projected that of the approximately 1 million students repaying loans, half (500,000) would claim the interest deduction for tax year 1998. Many would not be eligible due to the interest period limitation, AGI tests, home equity financing of loans for which interest is currently deductible, and defaults on loans. It was assumed that the average annual interest payment would be \$600 (one-half of an average annual payment of \$1,200). If a marginal tax rate of 4.5% is applied to these deductions, the impact would be around \$14 million.

#### BOARD POSITION

Pending.